4-2015

Marketplace Lending: Investors beware

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MARKETPLACE LENDING: INVESTORS BEWARE

Published:

29 Apr 2015

Marketplace lending could help finance SMEs that might otherwise be denied loans by banks, and investors could earn high returns by financing these deals. However, risk of default is high

In a report earlier this year, investment bank Goldman Sachs published a report titled “The Future of Finance – The rise of the new Shadow Bank”, which focused on the US$4 billion worth of non-bank loans in the U.S. Of particular interest was the growth of peer-to-peer (P2P) lending, where the two leading platforms, Lending Club and Prosper, accounted for US$1.7 billion in loans issuance in Q3 2014; in 2009, those two platforms lent only $26 million.

“If a small business or startup wants to borrow money, banks will ask for three-year financials,” says **Anju Patwardhan,**Group Head for Risk Innovation at Standard Chartered Group. “Most startups and new companies don’t have that record but they need the money in year 1. So what do they do? They up borrowing from family and non-banks.”

A ONE-SIDED BUSINESS

P2P lending – now better known as marketplace lending because it’s no longer directly from lender to borrower but through a platform or marketplace such as Lending Club – is the fastest growing banking segment. Goldman Sachs estimates that it will lose US$11 billion worth of profits to marketplace lending platforms over the next five years.

While it may benefit borrowers who might otherwise be denied a loan by a regular bank, the benefits for investors are not so straightforward. Lending platforms such as Lending Club, OnDeck, and Funding Circle pay a higher interest rate than bank deposits – about two to three percent more on average – and they rate borrowers according to their risk of default just like banks do i.e. higher risk, higher returns. However, that’s where the similarities end.

“They call themselves lenders but that’s not technically correct because they don’t lend any money to anybody,” explains Patwardhan. “They’re just the facilitators. For borrowers, it’s not that different from taking a loan from a bank – in terms of features, it’s similar to a mortgage or a small business loan. These platforms, however, partner with a bank for things such as pulling credit reports and underwriting etc.

“What about the investors? The investors get notes – the note usually states that the investor is taking the full risk, and the investor only gets paid when the borrower pays the principal and interest back. There is no obligation for the platform to pay anything to the note issuers. The platforms make it very clear on their websites that investors could lose everything.”

While these investors lend the money and take on the full risk of default but reap limited returns, lending platforms run a profitable operation with zero risk and liability.

“These platforms make money on both sides,” Patwardhan elaborated at the recent SMU SKBI seminar, ‘*Marketplace Lending*’. “When they give a loan, they typically deduct from the borrower two to five percent of the loan amount upfront – that’s a huge number. I’m surprised people agree to it because you get $9,500 when you apply for a $10,000 loan. The platforms make their money as soon as they make the loan, as opposed to banks who only make money when the interest income comes in.”

She adds, “When investors get their return in instalments, these platforms get a cut of the money in the form of a servicing fee, which is one percent of each instalment. So if each instalment is $500, the platform gets $50 each month on top of the $500 it took at the very beginning.”

A FANTASTIC BUSINESS MODEL...FOR WHOM?

Patwardhan describes it as a “fantastic business model”, and plenty of people around the world share the same sentiments. According to China’s state-owned newspaper, China Daily, there were 1,627 lending platforms in the country as of February 2015. 69 of them either went bankrupt or faced cash flow issues in the preceding month, which followed the 92 others that ran into trouble in December 2014.

“As more companies join the crowded field, they are forced to cut prices and go down to the lower credit rates to generate loan growth,” says Patwardhan. “If they have already done an IPO, they need the growth to justify market price. If they have not done an IPO, they need to keep showing growth in order to do so.”

To make matters worse, institutional investors are getting into the action and they are cherry picking the best loans. What is left for retail investors are “pretty much the bad loans”, says Parwardhan, which makes an already dubious investment option an even worse prospect. When asked if she thought those who choose to lend money on lending platforms are either gamblers or being optimistic, she was diplomatic.

“I would say those who give loans via marketplace lending are just ill—informed,” she said before adding, “but would I ever lend money this way? Never.”